(1)

Supreme Court, U.S.
FILED

96 235 AUG 12 1995

OFFICE OF THE CLERK

No. _____

In The

Supreme Court of the United States

October Term, 1995

FRANCHISE TAX BOARD
OF THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

DANIEL E. LUNGREN,
Attorney General of the
State of California
TIMOTHY G. LADDISH,
Assistant Attorney General
CAROL H. REHM, JR.,
Supervising Deputy Attorney
General
ANTHONY SGHERZI,
Deputy Attorney General
(Counsel of Record)
300 South Spring Street
Los Angeles, California 90013
(213) 897-2488
Attorneys for Petitioner
Franchise Tax Board of the
State of California

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

74 pp

QUESTION PRESENTED

When substantive tax law imposes the ultimate burden of proof upon a deduction-claiming taxpayer, is that ultimate burden of proof shifted to the taxing government when a tax claim is litigated in the bankruptcy court?

TABLE OF CONTENTS

Page

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iii

OPINIONS BELOW 1

JURISDICTION 1

CONSTITUTIONAL PROVISIONS, STATUTE AND RULES INVOLVED 2

STATEMENT OF CASE 2

REASONS FOR GRANTING THE WRIT 5

I. THE NINTH CIRCUIT'S DECISION IN THIS CASE IS IN DIRECT CONFLICT WITH THE DECISION OF THE FOURTH CIRCUIT WHICH HOLDS THAT THE ULTIMATE BURDEN OF PROVING BAD DEBT DEDUCTIONS IS NOT SHIFTED FROM THE TAXPAYER IN THE BANKRUPTCY CONTEXT 5

II. BY HOLDING THAT A BANKRUPTCY CONTEXT SHIFTS THE ULTIMATE BURDEN OF PROOF TO THE GOVERNMENT IN LITIGATING ENTITLEMENT TO A BAD DEBT TAX DEDUCTION, THE NINTH CIRCUIT HAS WRONGLY DECIDED A RECURRING ISSUE INVOLVING IMPORTANT POLICY CONSIDERATIONS 6

III. THE NINTH CIRCUIT'S HOLDING IS NOT REQUIRED BY ANY RULES OF UNIFORMITY; THE SPIRIT UNDERLYING THE UNIFORMITY REQUIREMENT OF THE CONSTITUTION'S BANKRUPTCY CLAUSE CALLS FOR THE GRANTING OF CERTIORARI IN THIS CASE ... 11

CONCLUSION 12

TABLE OF AUTHORITIES

Page

CASES

American Dredging Co. v. Miller, 510 U.S. ___, 114 S.Ct. 981 (1994) 7

BFP v. Resolution Trust Corp., 114 S.Ct. 1757 (1994) 8

Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974) 9

Director, OWCP v. Greenwich Collieries, 510 U.S. ___, 114 S.Ct. 2251 (1994) 7

English v. General Electric Co., 496 U.S. 72 (1991) 8

In re Landbank Equity Corp. (Internal Revenue Service v. Levy), 973 F.2d 264 (4th Cir. 1992) 6, 7, 10

Krumpotich v. Franchise Tax Board, 26 Cal.App.4th 1667, 31 Cal.Rptr.2d 896 (1994) 8

Railway Labor Executives Assn. v. Gibbons, 455 U.S. 457 (1982) 11

Resyn Corp. v. United States, 851 F.2d 660 (3rd Cir. 1988) 10

United States v. General Dynamics Corp., 481 U.S. 239 (1987) 5, 8

United States v. New York, N.H. & H.R. Co., 355 U.S. 253 (1957) 9

STATUTES

11 U.S.C. § 505 7

28 U.S.C. § 1254(1) 1

Cal. Rev. & Tax. Code § 17201 5

TABLE OF AUTHORITIES – Continued

Page

CONSTITUTIONAL PROVISIONS

U. S. Const., art. I, sec. 8, cl. 4 11

OTHER AUTHORITIES

Bankruptcy Rule 3001(f) 8

Bankruptcy Rule 9014..... 7

Countryman, The Use of State Laws in Bankruptcy Cases (Part I) 47 N.Y.U.L.R. 407 (1972)..... 8

PETITION FOR WRIT OF CERTIORARI

This petition for a writ of certiorari seeks this Court's review of the decision and opinion of the United States Court of Appeals For the Ninth Circuit, filed May 13, 1996. Unless this Court acts, this decision will result in an intercircuit conflict with respect to the important and recurring issue of whether the ultimate burden of proving entitlement to a bad debt deduction from state personal income tax is reversed when litigating claims for taxes in the bankruptcy forum.

OPINIONS BELOW

The opinion of the United States Bankruptcy Court, Southern District of California, (Appendix "C") is an unreported decision. The memorandum opinion of the United States District Court, Southern District of California, (Appendix "B") is an unreported decision. The opinion of the United States Court of Appeals For the Ninth Circuit (Appendix "A") was reported at 83 F.3d 1041 (9th Cir. 1996).

JURISDICTION

Jurisdiction of this Court to review the final order of the United States Court of Appeal for the Ninth Circuit is invoked pursuant to 28 U.S.C. § 1254(1). Pursuant to Rule 13 of the Rules of the United States Supreme Court the petition is required to be filed within 90 days after the

entry of judgment. The Ninth Circuit decided the matter and entered judgment on May 13, 1996.

CONSTITUTIONAL PROVISIONS, STATUTE AND RULES INVOLVED

(The text is provided at Appendix "D")

United States Constitution, art. I, sec, 8, cl. 4..... App. D

28 U.S.C. Sec. 1254(1)..... App. D

26 U.S.C. Sec. 166 ..... App. D

11 U.S.C. Sec. 505 ..... App. D

California Revenue & Taxation Code Sec. 17201 ..... App. D

Bankruptcy Rule 3001(f) ..... App. D

Bankruptcy Rule 9014..... App. D

STATEMENT OF CASE

William Cheng was a certified public accountant who handled all of investor Stephen B. Macfarlane's ("Macfarlane") financial, business and tax matters during 1988 and 1989. Through the execution of 19 powers of attorney, Macfarlane empowered Cheng to act with respect to all of Macfarlane's business, financial, investments, and tax matters – without monetary limitation.

Using these powers of attorney, Cheng made cash withdrawals and advances to himself from the proceeds of Macfarlane's accounts controlled by the powers of

attorney. In this manner, Cheng distributed $1,632,500 to himself in 1988 and $2,224,077 to himself in 1989 in a series of transactions in amounts as high as $500,000. While some of the distributions were purportedly for the purpose of investments in such enterprises as Cheng Information Systems, a company owned and controlled by William Cheng, Macfarlane was unaware that many of these transactions were actually used for Cheng's personal benefit. In exchange for the cash advances taken from Macfarlane's accounts, Cheng provided Macfarlane with unsecured promissory notes.

As Macfarlane's tax preparer, Cheng provided Macfarlane with blank state tax returns for tax years 1988 and 1989. Macfarlane signed the blank returns and forwarded the returns back to Cheng. Cheng then proceeded to complete the information on the returns listing as bad debt deductions the amounts which he had withdrawn from Macfarlane's accounts in 1988 and 1989, pursuant to the powers of attorney. Macfarlane had no knowledge of the contents of the tax returns at the time Cheng filed them with the state. Finding a lack of substantiation with respect to the deductions taken on Macfarlane's 1988 and 1989 state tax returns, the state disallowed the deductions and issued notices of proposed assessment.

Macfarlane filed bankruptcy in 1990 and Cheng filed bankruptcy in 1991. After filing bankruptcy, Macfarlane revoked the powers of attorney he had provided to Cheng. Macfarlane filed a protective proof of claim in his bankruptcy estate with respect to his state tax obligations. The state filed amended proofs of claim based upon the disallowance of Macfarlane's 1988 and 1989 bad debt deductions.

Macfarlane objected to the state's proofs of claim, alleging that he was entitled to a bad debt deduction; he requested a summary determination. Both sides filed pleadings supporting their respective positions. The pleadings filed by the State asserted that the debtor, Macfarlane, bore the ultimate burden of providing entitlement to the bad debt deduction which the state had disallowed based upon a lack of substantiation; the state also asserted that ultimate issues of material fact existed with respect to the controversy. After a hearing was held in the bankruptcy court, the court disallowed the state's amended proofs of claim, granting summary affirmance of the claim, and held that it was the state who bore the ultimate burden of proving that the debtor was not entitled to the deductions taken on his returns.

The state filed a notice of appeal, and the matter was ultimately heard by the district court. On June 29, 1994, the district court entered its judgment and memorandum decision affirming the bankruptcy court's denial of the state's amended proofs of claim and reversing the bankruptcy court's summary determination, holding that genuine issues of material fact existed. Macfarlane filed a motion for reconsideration on the issue of summary determination, which motion was denied.

On July 15, 1994, the state appealed to the United States Court of Appeals for the Ninth Circuit and the debtor filed a cross-appeal. The matter was argued on March 6, 1996. The opinion of the Ninth Circuit was entered on May 13, 1996. That decision affirmed the holding of the district court which denied the state's proof of claim and reversed the holding of the district court which had held that genuine issues of material fact

existed. From that decision, the state has filed this petition with the Court.

REASONS FOR GRANTING THE WRIT

I.

THE NINTH CIRCUIT'S DECISION IN THIS CASE IS IN DIRECT CONFLICT WITH THE DECISION OF THE FOURTH CIRCUIT WHICH HOLDS THAT THE ULTIMATE BURDEN OF PROVING BAD DEBT DEDUCTIONS IS NOT SHIFTED FROM THE TAXPAYER IN THE BANKRUPTCY CONTEXT

As recognized by the Ninth Circuit below, "There is no question that outside the bankruptcy forum, a taxpayer bears the ultimate burden of providing entitlement to a deduction. *United States v. General Dynamics Corp.*, 481 U.S. 239, 245 (1987)." (App. at A7.) Citing cases from the Fifth, Eighth and Tenth Circuits on one side and the Third and Fourth Circuits on the other, the Ninth Circuit also recognizes that "[c]ourts have struggled in deciding whether to import the taxpayers' ultimate burden of proof into bankruptcy proceedings." (App. at A8.) Like the Ninth Circuit, the Fourth Circuit also has directly addressed the specific issue of whether it is the debtor or the creditor which bears the ultimate burden of proof regarding entitlement to a bad debt deduction in bankruptcy claims adjudication. In a case involving claimed federal-tax bad-debt deductions,[1] the Fourth Circuit held that the ultimate burden of proving entitlement

[1] California law includes by reference the federal tax laws regarding bad debt deductions. California Revenue and Taxation Code § 17201.

to the bad debt deduction remains on the taxpayer-debtor. *In re Landbank Equity Corp. (Internal Revenue Service v. Levy)*, 973 F.2d 264 (4th Cir. 1992). The Ninth's Circuit's decision here runs directly counter to the Fourth Circuit's decision in *Landbank Equity*.

In this case the Ninth Circuit explicitly declined to follow *Landbank Equity*, holding that, "[w]hile we agree with the Board that *Landbank* is strong support for the Board's position, we do not agree with its analysis or conclusion. Nor do we consider *Landbank* controlling or persuasive because it is the only circuit decision to rule specifically on the allocation of burdens in a bankruptcy proceeding when a debtor's bad debt deduction is challenged." (App. at A9.) Thus, a direct intercircuit conflict exists with respect to this issue. This Court is urged to resolve that conflict.

II.

BY HOLDING THAT A BANKRUPTCY CONTEXT SHIFTS THE ULTIMATE BURDEN OF PROOF TO THE GOVERNMENT IN LITIGATING ENTITLEMENT TO A BAD DEBT TAX DEDUCTION, THE NINTH CIRCUIT HAS WRONGLY DECIDED A RECURRING ISSUE INVOLVING IMPORTANT POLICY CONSIDERATIONS

At issue in this case is whether a bankruptcy proceeding shifts the ultimate burden of proof regarding entitlement to income tax deductions. This is an issue

which recurs every time there is a bankruptcy court challenge to a governmental claim which is based on a disallowance of such a deduction.[2] Given the immense aggregate amount of public revenues at issue in such challenges, it is vitally important to resolve the issue of whether the burden of proof is reversed in litigating entitlement to a tax deduction in the bankruptcy court.

"[T]he assignment of the burden of proof is a rule of substantive law. . . . " *Director, OWCP v. Greenwich Collieries*, 510 U.S. ___, ___, 114 S.Ct. 2251, 2254 (1994), citing *American Dredging Co. v. Miller*, 510 U.S. ___, 114 S.Ct. 981, 988 (1994). As the Fourth Circuit correctly held in *Landbank*: "In resolving disputed claims against the bankruptcy estate, it is important to understand that the Bankruptcy Code, in most circumstances, while providing a forum and procedures for an expedient dispute resolution, does not endeavor to supplant the substantive law under which the claim against the estate . . . arose." *In re Landbank Equity Corp.*, 973 F.2d at 270 (citing Report on the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93rd Cong. 1st Sess. Pt. I, pp. 68-71, 76-78 (1973)). The Fourth Circuit also correctly noted that "[i]t would appear that the substantive law regarding claims against the estate gives way only in those instances in which the internal goals of the bankruptcy system require alteration of externally created substantive rights," and that those exceptions are to be

---

[2] In this case, the issue of entitlement arose as a result of a contested matter pursuant to Bankruptcy Rule 9014. This same issue can arise pursuant to 11 U.S.C. section 505.

(and have been) specifically provided for by Congress in the Bankruptcy Code. *Id.*

Absent a "clear and manifest" federal statutory purpose to displace traditional state regulation, the Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law. *BFP v. Resolution Trust Corp.*, 510 U.S. ___, ___, 114 S.Ct. 1757, 1764-1765 (1994),[3] citing *English v. General Electric Co.*, 496 U.S. 72, 79 (1991). The Ninth Circuit's decision explicitly recognizes that "[t]he bankruptcy code is silent on the allocation of the ultimate burden of proof in this case.[4] (App. at A9.) Under these circumstances, the substantive tax law regarding burden of proof as to tax deductions is not preempted and is equally applicable in the bankruptcy context.

In both federal and California substantive income tax law, the ultimate burden of proving entitlement to a bad debt deduction falls clearly on the debtor. *United States v. General Dynamics Corp.*, 481 U.S. at 245; *Krumpotich v. Franchise Tax Board*, 26 Cal.App.4th 1667, 1671, 31 Cal.Rptr.2d 896, 899 (1994).[5] Under the above authorities,

---

[3] Also see: Countryman, *The Use of State Laws in Bankruptcy Cases (Part I) 47 N.Y.U.L.R. 407 (1972).*

[4] Bankruptcy Rule 3001(f) simply establishes that a proof of claim constitutes evidence. The rule does not allocate burdens of proof.

[5] In this case, the Ninth Circuit held, erroneously, that the California Franchise Tax Board had the ultimate burden of proof in bankruptcy court; it also held that the Franchise Tax Board had not satisfied this purported burden. Further, the Ninth Circuit held that the taxpayer had satisfied the only burden of proof which the court assigned to the taxpayer: an intermediate

the Ninth Circuit erred in not applying this substantive tax law in the bankruptcy context.

In the absence of the required clear congressional preemption of the substantive tax law, the Ninth Circuit endorsed a preemption of California law by the bankruptcy courts' attempt to balance the equities. (App. at A 9.) This Court has recognized that the propriety of a tax deduction does not turn upon general equitable considerations; it depends upon legislative grace. *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).

The substantive tax law's assignment of the burden of proof to the taxpayer is not an unfair aberration. "The ordinary rule, based on considerations of fairness, does not place the burden upon a litigant of establishing facts peculiarly within the knowledge of his adversary." *United States v. New York, N.H. & H.R. Co.*, 355 U.S. 253, 256 n. 5 (1957). The basis for entitlement to a bad debt deduction relies upon facts which are peculiarly within the knowledge of the taxpayer. As a result of the possession of this knowledge, logic dictates that the taxpayer must bear the ultimate burden of proving entitlement to the claimed bad debt deduction.

---

burden of only submitting sufficient evidence to rebut the prima facie validity of the Board's Claim. (App. at A8, 10.) Reversal of the Ninth Circuit's holding that the Board had the ultimate burden of proof would require a remand for consideration of whether taxpayer had satisfied the ultimate burden of providing entitlement to the bad debt deduction claimed by taxpayer.

While a debtor-taxpayer should be afforded no fewer rights in adjudicating a claim against a tax agency in a bankruptcy forum by happenstance of filing bankruptcy, the logic and rationale clearly articulated in *Landbank Equity* mandates that the debtor-taxpayer should not be afforded any greater right in adjudicating his claim by the filing of bankruptcy. *See also, Resyn Corp. v. United States*, 851 F.2d 660, 662-663 (3rd Cir. 1988).

If this decision is allowed to stand, the ruling of the Ninth Circuit will provide the debtor with an unwarranted benefit by shifting the ultimate burden of proof regarding entitlement to a tax deduction onto the governmental agency, even though the taxpayer, the party to whom the substantive tax law has allocated the ultimate burden of proof, is the party who has much superior access to the facts of the controversy. Without a granting of certiorari by this Court, a taxpayer with significant tax obligations will be encouraged to thwart those obligations by placing an insurmountable burden of proof on the taxing agency through the taxpayer's escape into the bankruptcy courts.

III.

THE NINTH CIRCUIT'S HOLDING IS NOT REQUIRED BY ANY RULES OF UNIFORMITY; THE SPIRIT UNDERLYING THE UNIFORMITY REQUIREMENT OF THE CONSTITUTION'S BANKRUPTCY CLAUSE CALLS FOR THE GRANTING OF CERTIORARI IN THIS CASE

As noted above, the Ninth Circuit's decision in this case inappropriately displaces state law which is applicable to a determination of entitlement to a bad debt deduction. In large part the Ninth Circuit relies upon "the logic" of an admittedly "broad" rule that taxing authorities are to be treated the same as other claimants. (App. at A9.) The bankruptcy clause of the United States Constitution (art. I, sec. 8, cl. 4), which empowers Congress to establish "uniform laws on the subject of bankruptcies," does not forbid Congress from distinguishing among classes of creditors; nor does it prohibit Congress from recognizing that state laws do not treat commercial transactions in a uniform manner, even though such recognition may lead to different results in different states. *Railway Labor Executives Assn. v. Gibbons*, 455 U.S. 457, 469 (1982).

The fact that the application of substantive law to the claims adjudication process in bankruptcy court may yield differing effects upon different types of creditors, or upon the same types of creditors in different states, is insufficient reason to refuse to apply state law. Under the rule stated by this Court in *Railway Labor Executives Assn.*, the equality of treatment of all creditors includes the application of appropriate substantive law in adjudicating creditors' claims.

As noted above, the conflicts between the circuits has resulted in a very real need for a uniform court rule regarding whether the burden of proof which is imposed by substantive tax law upon a deduction-claiming taxpayer is shifted to the taxing government when a tax claim is litigated in the bankruptcy court. The Ninth Circuit's decision has added to the conflict between the circuits in the general taxes-in-bankruptcy area, and it has created a direct and specific conflict with the Fourth Circuit with regard to bankruptcy tax claims arising from bad debt deductions. The spirit underlying the uniformity requirement of the United States Constitution's bankruptcy clause calls for the granting of certiorari so that this Court can establish uniformity in this area of uncertainty.

CONCLUSION

Under applicable substantive nonbankruptcy law the taxpayer bears the ultimate burden of proving entitlement to a bad debt deduction. With its decision, the Ninth Circuit has inappropriately shifted this burden to the taxing government. In the absence of express action of Congress, the courts should not take upon themselves to preempt the substantive tax law by shifting this burden of proof to the party which, by the nature of the controversy, has much less access to the determinative facts.

At this time an intercircuit conflict exists among the circuits (Fourth and Ninth Circuits) with respect to

whether the ultimate burden of proof is reversed in bankruptcy court when litigating claims involving entitlement to a bad debt deduction. This clear intercircuit conflict on an important and recurring issue needs to be clarified by this Court.

Respectfully submitted,

DANIEL E. LUNGREN,
Attorney General of the
State of California
TIMOTHY G. LADDISH,
Assistant Attorney General
CAROL H. REHM, JR.,
Supervising Deputy Attorney
General
ANTHONY SGHERZI,
Deputy Attorney General
(Counsel of Record)

Attorneys for Petitioner
Franchise Tax Board of the
State of California

APPENDIX "A"

In re Stephen MACFARLANE, Debtor.

FRANCHISE TAX BOARD OF the STATE OF CALIFORNIA,
Creditor-Appellant-Cross-Appellee,

v.

Stephen MACFARLANE, Debtor-Appellee-Cross-Appellant.

Nos. 94-56064, 94-56065.

United States Court of Appeals,
Ninth Circuit.

Argued and Submitted March 6, 1996.

Decided May 13, 1996.

California Franchise Tax Board filed claim for state income taxes, alleging that debtor's bad debt deductions were invalid. The Bankruptcy Court entered judgment for debtor, and Board appealed. The United States District Court for the Southern District of California, John Rhoades, Sr., J., reversed judgment, ruling that inferences from debtor's evidence raised triable issues of fact. Parties both appealed. The Court of Appeals, Skopil, Senior Circuit Judge, held that: (1) taxing authority has ultimate burden of proving its claim in bankruptcy proceedings, and (2) Board's reliance on alleged inconsistencies in bankrupt debtor's evidence was insufficient to meet Board's burden of proving its claim for taxes on ground that debtor's bad debt deductions were invalid.

Reversed and remanded.

Anthony Sgherzi, Deputy Attorney General, Los Angeles, California, for appellant-cross-appellee Franchise Tax Board of the State of California.

Elmer Dean Martin III, Diamond Bar, California, for appellee cross-appellant debtor Stephen B. Macfarlane.

On Appeal from the United States District Court for the Southern District of California; John S. Rhoades, District Judge, Presiding. D.C. No. CV-93-01435-JSR.

Before: SKOPIL, Senior Circuit Judge, CANBY, and LEAVY, Circuit Judges.

SKOPIL, Senior Circuit Judge:

We address in these appeals which party has the ultimate burden of proof in bankruptcy proceedings when a state files a claim for taxes alleging that a debtor's bad debt deductions are invalid. Both the bankruptcy and district courts held that the state bears the burden of proving its claim. The bankruptcy court determined that the state failed to meet its burden and entered judgment in favor of the debtor; the district court reversed, ruling that inferences drawn from the evidence create triable issues of fact. We affirm the allocation of the burden of proof; we reverse the district court's ruling and we reinstate and affirm the judgment of the bankruptcy court.

I.

Stephen B. Macfarlane (debtor) filed for bankruptcy in 1990. The Internal Revenue Service (IRS) filed a claim alleging that he owed additional taxes for 1988-89 because certain bad debt deductions were invalid. At issue were cash advances made by debtor to his financial

consultant and accountant, William Cheng, in exchange for unsecured promissory notes. The IRS contended that the advances were failed investments rather than loans. The claim was settled.

The California Franchise Tax Board (Board) thereafter filed its claim in bankruptcy court for state income taxes based on the invalidity of the same bad debt deductions. The bankruptcy court ruled that the Board's claim was prima facie valid; that debtor timely filed an objection to the claim; and that debtor provided the court with sufficient evidence to establish that the debts existed in 1988-89 and became worthless in those respective years. The court ruled that the burden shifted to the Board to prove the factual basis for its claim. The court continued the proceedings to allow the Board to conduct discovery to support its claim.

The Board elected not to conduct discovery or to submit evidence. On the basis of the evidence submitted by debtor, the bankruptcy court entered the following findings of fact:

1. The California Franchise Tax Board filed its claims in the above captioned case for income taxes, interest, additions and penalties claimed to be due from Debtor measured by his taxable income for 1988 and 1989.

2. The Debtor filed an objection to such claims, offered admissible evidence in opposition to such claims, and requested a determination of his personal liability and the liability of his estate in the above captioned case.

3. Debtor timely filed income tax returns for 1988 and 1989 with the California Franchise Tax Board claiming as deductions from income nonbusiness bad debt amounts claimed to be due to Debtor from William Cheng.

4. The deductions claimed by Debtor on these returns were $1,400,000 for 1988 and $1,378,141 for 1989.

5. Prior to December 31, 1988, Cheng had obtained at least $1,632,500 from Debtor and promised to repay this amount.

6. In 1989 Cheng obtained an additional $2,047,232 to $2,224,077 from Debtor and promised to repay this amount.

7. Cheng prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns which claimed the deductions described in statement number 4 above for amounts due from Cheng.

8. Cheng knew when he prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns that he could not repay the amounts he had borrowed from Debtor and accordingly prepared the returns to claim a loss for amounts due from him.

9. In April 1991 Cheng commenced a bankruptcy case under Chapter 13 of Title 11 U.S.C., and his case was converted to Chapter 7 in May 1991. Cheng admitted in his bankruptcy schedules of liabilities that he was indebted to Debtor in the amount of $2,939,722.00.

10. Cheng's bankruptcy estate has little or no value.

11. The primary asset of Cheng's estate was stock in Cheng Information Systems, Inc.

12. All of the property of Cheng Information Systems, Inc. was sold by its trustee for $2,500.

13. On December 31, 1988 and December 31, 1989, Cheng's promises to pay Debtor amounts owed to him as of such dates were worthless.

14. As of December 31, 1988 and December 31, 1989, Debtor had no realistic prospect of recovery from Cheng of any of the amounts then due to Debtor.

15. Cheng was unable to obtain a loan in 1988 or 1989 without Debtor's accommodation as a co-maker.

16. Debtor and Cheng signed documents evidencing an intent to enter into a debtor and creditor relationship and each stated orally to witnesses from time to time that a debtor-creditor relationship between them existed.

17. Cheng was in dire financial straits in 1988 and by the end of 1989 was living off loans.

18. Debtor loaned a total of $4,529,349 to Cheng.

On the basis of these findings, the bankruptcy court ruled that "Cheng was indebted to Debtor in the amounts and at the times claimed by Debtor, and such debts were worthless on December 31, 1988 and December 31, 1989

as claimed by Debtor." Judgment was entered in favor of debtor.

The Board appealed to the district court. The district court agreed with the bankruptcy court that the Board has the ultimate burden of proving its tax claim in bankruptcy proceedings. The court also agreed that whether debtor's transactions were loans and whether those loans became worthless are questions of fact. The district court reviewed the record and concluded that "[b]ased on the facts presented and the reasoning of the authorities cited . . . , the court finds the bankruptcy court's ruling was not clearly erroneous and affirms the bankruptcy court's findings of fact."

Notwithstanding that affirmance, the district court concluded that although the Board submitted no evidence and the bankruptcy court's findings were not clearly erroneous, inferences drawn from debtor's evidence raise triable issues of fact. The district court entered judgment affirming the bankruptcy court's findings of fact, but reversing the bankruptcy court's judgment.

II.

We are confronted initially by a jurisdictional concern that the district court's reversal of the bankruptcy court's judgment is not a final order because further proceedings in bankruptcy court are contemplated. Appellate jurisdiction exists only when the bankruptcy and district courts' decisions are final orders. *In re Dominguez*, 51 F.3d 1502, 1506 (9th Cir.1995). We have taken a pragmatic approach, however, to determining finality for purposes of asserting jurisdiction arising from a district court's review of a

bankruptcy decision. *See In re United Ins. Manag., Inc.*, 14 F.3d 1380, 1384 (9th Cir.1994). The district court's order will be considered final even if it remands for further proceedings in the bankruptcy court. *See id.; In re Sambo's Restaurants, Inc.*, 754 F.2d 811, 814-15 (9th Cir.1985). Thus, we have jurisdiction. Our standard of review is the same as that of the district court. *In re DAK Indus., Inc.*, 66 F.3d 1091, 1094 (9th Cir.1995). "Therefore, we review the bankruptcy court decision directly." *Id.* The bankruptcy court's findings of fact are reviewed for clear error; its conclusions of law are reviewed de novo. *Id.*

III.

There is no question that outside the bankruptcy forum, a taxpayer bears the ultimate burden of proving entitlement to a deduction. *United States v. General Dynamics Corp.*, 481 U.S. 239, 245, 107 S.Ct. 1732, 1737, 95 L.Ed.2d 226 (1987). The government's initial burden is satisfied by filing a claim that is deemed to be presumptively accurate. *McKay v. United States*, 957 F.2d 689, 691 (9th Cir.1992). The burden of proof then shifts to the taxpayer. *Oliver v. United States*, 921 F.2d 916, 919 (9th Cir.1990). The taxpayer is required to prove the merits of a claimed deduction by a preponderance of the evidence. *Rockwell v. Commissioner*, 512 F.2d 882, 885 (9th Cir.), *cert. denied*, 423 U.S. 1015, 96 S.Ct. 448, 46 L.Ed.2d 386 (1975). Similarly, under California law, a taxpayer claiming a deduction bears the ultimate burden of proving facts to justify the deduction. *Krumpotich v. Franchise Tax Bd.*, 26 Cal App.4th 1667, 1671, 31 Cal.Rptr.2d 896, 899, *review denied* (Oct. 13, 1994).

In bankruptcy proceedings, a properly filed claim constitutes prima facie evidence of the validity and amount of the claim. 11 U.S.C. §§ 501, 502(a). The debtor or trustee has the burden of presenting evidence to rebut this prima facie validity. If that burden is met, the creditor must present evidence to prove the claim. The ultimate burden of proof therefore is on the creditor. *See In re Holm*, 931 F.2d 620, 623 (9th Cir.1991); *United States v. Sampsell*, 224 F.2d 721, 722-23 (9th Cir.1955).

Courts have struggled in deciding whether to import the taxpayer's ultimate burden of proof into bankruptcy proceedings. *See, e.g., In re Wilhelm*, 173 B.R. 398, 401-02 (Bankr.E.D.Wis.1994) (deciding that IRS bears ultimate burden); *In re Premo*, 116 B.R. 515, 518-24 (Bankr.E.D.Mich.1990) (same). Unfortunately, "[t]he case law on this issue is divided with neither side making an overwhelmingly convincing argument." *Wilhelm*, 173 B.R. at 402. The Fifth, Eighth and Tenth Circuits reviewed the issue and concluded that the taxing authority bears the ultimate burden of proof in bankruptcy proceedings. *See Matter of Placid Oil Co.*, 988 F.2d 554, 557 (5th Cir.1993); *In re Gran*, 964 F.2d 822, 827-28 (8th Cir.1992); *In re Fullmer*, 962 F.2d 1463, 1466 (10th Cir.1992). The Third and Fourth Circuits reached the opposite conclusion. *Resyn Corp. v. United States*, 851 F.2d 660, 663 (3d Cir.1988); *In re Landbank Equity Corp.*, 973 F.2d 265, 268-72 (4th Cir.1992).

The Board urges us to adopt the reasoning of *Landbank* that bankruptcy courts are generally required to apply the substantive law under which the claim arose, that there is no indication that Congress implicitly intended the bankruptcy code to amend the substantive tax law regarding the taxpayer's burden of proof, and

that equity considerations do not provide a basis for shifting the taxpayer's burden of proof to the government. *Landbank*, 973 F.2d at 270-72. While we agree with the Board that *Landbank* is strong support for the Board's position, we do not agree with its analysis or conclusion. Nor do we consider *Landbank* controlling or persuasive because it is the only circuit decision to rule specifically on the allocation of burdens in a bankruptcy proceeding when a debtor's bad debt deduction is challenged. Other circuit decisions clearly establish a broad rule that taxing authorities are to be treated the same as other claimants and must therefore bear the ultimate burden of proving their claims in bankruptcy. *See, e.g., Matter of Fidelity Holding Co.*, 837 F.2d 696, 698 (5th Cir.1988) ("The Bankruptcy Code . . . does not differentiate between government and private claimants when proofs of claim are filed."). The logic of that rule is compelling to us, and accordingly, we hold that the taxing authority has the ultimate burden of proof in the bankruptcy forum.

The bankruptcy code is silent on the allocation of the ultimate burden of proof in this case. In the absence of a statutory directive, we consider it appropriate to turn to policy considerations that underlie the bankruptcy code. The district court concluded that it should balance the equities "between the Board and the other creditors of Debtor's estate." The court reasoned that since tax claims already receive a statutory priority over other creditor's claims, 11 U.S.C. § 507(a)(8)(A), relieving the Board of its burden of proof "would be granting the Board a double benefit not authorized by statute or Ninth Circuit authority." We agree. "[T]he policy goals of the bankruptcy system are put at risk when one class of creditors is given

the benefit of a favorable presumption which has its origins outside of bankruptcy law." *Wilhelm*, 173 B.R. at 402. Accordingly, we affirm the bankruptcy and district courts' rulings that the taxing authority has the ultimate burden of proving its claim in bankruptcy proceedings.

IV.

A bad debt deduction can be claimed when there is a bona fide debt and the debt became wholly worthless during the year claimed. *See* 26 U.S.C. § 166(d); Cal.Rev. & Tax.Code § 17201. The bankruptcy court reviewed the evidence submitted by debtor and found that these requirements had been fulfilled. The district court affirmed the bankruptcy court's findings. We also conclude that the bankruptcy court's findings are not clearly erroneous.

That conclusion would normally end our inquiry in favor of debtor, but here the district court reversed the bankruptcy court's judgment. The district court ruled that inferences drawn from debtor's evidence raise triable issues of fact that preclude summary judgment. There is clearly doubt, however, whether the bankruptcy court entered summary judgment. The fact that the bankruptcy court resolved factual disputes, entered findings of fact, and made conclusions of law belie the contention that summary judgment procedures were used. *See Ojai Unified Sch. Dist. v. Jackson*, 4 F.3d 1467, 1472 (9th Cir.1993), *cert. denied*, ___ U.S. ___, 115 S.Ct. 90, 130 L.Ed.2d 41 (1994). Rather, it appears that the bankruptcy court ruled

in favor of debtor because he submitted sufficient evidence to rebut the Board's claim, and the Board failed to carry its burden of proof.

Nevertheless, even if summary judgment standards are applied, we agree with debtor that the bankruptcy court's decision should be affirmed. "Once the moving party demonstrates the absence of a genuine issue of material fact, the burden shifts to the nonmoving party to produce evidence sufficient to support a jury verdict in [its] favor." *Gasaway v. Northwestern Mut. Life Ins. Co.*, 26 F.3d 957, 959 (9th Cir.1994) (quotation omitted). "This requires the nonmoving party to go beyond the pleadings and show by . . . affidavits, or by the depositions, answers to interrogatories, or admissions on file, that a genuine issue of material fact exists." *Id.* (quotations omitted).

The Board submitted no evidence of its own, but rather sought to rely on alleged inconsistencies in debtor's evidence. We agree with debtor that the Board's reliance on this evidence is insufficient to meet its burden of proving its claim; the claimed inconsistencies are insubstantial and do not create genuine issues of material fact. The judgment of the district court is REVERSED and the case REMANDED to the bankruptcy court for entry of judgment in favor of Macfarlane.

REVERSED and **REMANDED.**

APPENDIX "B"

UNITED STATES DISTRICT COURT

Southern District of California

IN RE: STEPHEN B. MACFARLANE, Debtor

CALIFORNIA FRANCHISE TAX, Appellant

V.

STEPHEN B. MACFARLANE, Appellee

JUDGMENT IN A CIVIL CASE

(Filed Jun. 29, 1994)

CASE NUMBER: 93-1435 G/R

[ ] Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

[X] Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

the Bankruptcy Court's findings of fact and conclusions of law on the motion for denial of claim, Bankruptcy Docket #181, are affirmed and the Bankruptcy Court's grant of summary judgment denying the Board's claim, Bankruptcy Docket #235 is reversed .....

June 29, 1994
Date

Roberta Westdal
Clerk

M. Stottlemyer /s/ M. Stottlemyer
(By) Deputy Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF CALIFORNIA

IN RE: STEPHEN B. MACFARLANE, Debtor. CALIFORNIA FRANCHISE TAX Appellant, v. STEPHEN B. MACFARLANE, Appellee.	Civil No. 93-1435 G/R MEMORANDUM DECISION AFFIRMING IN PART AND REVERSING IN PART BANKRUPTCY COURT'S DECISION[1] (Filed Jun. 29, 1994)

ISSUES ON APPEAL:

1. Whether the bankruptcy court erred when it held that the California Franchise Tax Board, ("Board") has the ultimate burden of proof with respect to the issue of whether or not Stephen MacFarlane, ("Debtor") is entitled to a "bad debt deduction" for income tax purposes?

2. Whether the bankruptcy court was clearly erroneous when it found that the Debtor made loans in 1988 and 1989 and the loans were totally worthless by the end of 1988 and 1989?

3. Whether the bankruptcy court erred when it held that Debtor was entitled to a bad debt deduction as a

---

[1] Pursuant to Southern District of California Rule 7.1(d)(1) and Fed. R. Bankr. P. 8012(3) this court finds this appeal suitable for decision without oral argument.

matter of law, and granted summary judgment in favor of the Debtor disallowing the claim filed by the Board?

FACTS

During the years in question, William Cheng ("Cheng") handled the financial affairs of the Debtor as a consultant and accountant. The Debtor gave Cheng a general power of attorney in 1983 and numerous special powers of attorney. Cheng had the authority to act with respect to any of the Debtor's commercial, checking, savings or money market accounts. Cheng had the power to withdraw funds, sign all checks for bills and investments, and to buy, sell or borrow against the Debtors securities. Cheng maintained this authority during 1988 and 1989.

In 1988, the Debtor provided Cheng with approximately $1,632,500 in cash advances via unsecured promissory notes. In 1989, the Debtor provided Cheng with an additional $2,224,077 in cash advances via unsecured promissory notes.

Cheng prepared and signed the Debtor's tax returns in 1988 and 1989. The Debtor claimed bad debt deductions of $1,400,000 on his 1988 tax return and $1,378,141 on his 1989 return. The bad debt deductions claimed by Debtor resulted from the cash advanced to Cheng that he was unable to repay.

The Debtor filed bankruptcy in 1990. Cheng filed bankruptcy in 1991. In June of 1991, the Internal Revenue Service (IRS) issued an audit report which determined that the deduction for the bad debts at issue in this case should be disallowed. The Debtor contested the IRS claim

in bankruptcy court. In April of 1992, the Board issued a notice of proposed assessment disallowing the bad debt deductions on the Debtor's state return for 1988 and 1989. In October of 1992, the IRS and the Debtor settled the matter. The parties agreed that only $250,000 of the original $1,339,750 claim was owed by the Debtor and the Debtor withdrew another unrelated claim for refund. The Boards' notice of proposed assessment was not affected by the Debtor's settlement with the IRS.

PROCEDURAL HISTORY

The Board filed a proof of claim in the Debtor's estate, in August of 1993, for state income taxes. The Board's proof of claim resulted from a disallowance of a bad debt deduction taken on the Debtor's 1988 and 1989 state income tax returns. The Debtor filed an objection to the Board's proof of claim and the bankruptcy court scheduled a hearing for March 15, 1993.

At the March 15, 1993 hearing, the bankruptcy court held: the Board's proof of claim was prima facie valid; the Debtor timely filed an objection to the claim; the Debtor provided the court with sufficient evidence to establish that a debt existed between the parties in 1988 and 1989, and that the debt was worthless in 1988 and 1989. R.A. 169. In addition, the court held that the Board had the burden of persuasion to prove the factual basis for its claim. *Id.* at 170.

The bankruptcy court also granted the Board time to conduct discovery to support its claim and continued the matter to July 12, 1993. *Id.* at 170-72. The Board did not conduct any discovery during this period. *Id.* at 78-79. In

June of 1993, the Debtor filed a motion for summary determination denying the Board's claim. This motion was pursuant to Fed. R. Civ. P. 56 made applicable by Fed. R. Bankr. P. 7056. The bankruptcy court entered its judgment denying the Board's claim and its findings of fact and conclusions of law on August 10, 1993.

The Board filed its notice of appeal on August 19, 1993. On September 1, 1993, the Debtor objected to the reference of the appeal to the Bankruptcy Appellate Panel of the Ninth Circuit. The parties submitted the final briefs on January 5, 1994. This matter was referred to the Honorable Marilyn L. Huff during the absence of the Honorable Earl B. Gilliam. This appeal was calendared to be decided on May 9, 1994. On May 20, 1994 Judge Huff recused herself from the case because of a possible conflict. This appeal was reassigned to this court on May 20, 1994.

THE BANKRUPTCY COURT'S DECISION

At the July 12, 1993 hearing, Judge Bowie disallowed the Board's proof of claim; holding that the Debtor had no income tax liability to the Board for the period in question. The bankruptcy court made the following findings of facts relevant to this appeal: (1) Cheng had obtained $1,632,500 from Debtor prior to December 31, 1988 and promised to repay that amount; (2) in 1989, Cheng obtained an additional $2,047,032 to $2,224,077 and promised to repay that amount; (3) on December 31 1988, and December 31 1989, Cheng's promises to pay the Debtor the amounts owed were worthless; (4) Cheng knew the debts were worthless when he prepared the

Debtor's 1988 and 1989 state franchise tax returns, and accordingly claimed a loss for the amounts due from him; (5) Debtor and Cheng signed documents evidencing an intent to create a debtor-creditor relationship and each stated to witnesses that a debtor-creditor relationship existed.

In addition, at the July 12, 1993 hearing the bankruptcy court made the following conclusions of law relevant to this appeal: (1) the Board's proof of claim is presumptively entitled to prima facie validity, until Debtor presents admissible evidence which tends to rebut the presumption; (2) the Debtor met his burden of rebutting the presumption in this case; (3) the Board has the ultimate burden of proof on the validity of the claim at issue; (4) a debt is an obligation to pay money; (5) Cheng agreed to pay Debtor the amounts claimed by Debtor on his 1988 and 1989 returns; (6) a debt is deductible when it becomes worthless; (7) a debt is worthless when there is no reasonable possibility of repayment and there are reasonable grounds for abandoning any hope of payment in the future; (8) Cheng's debts to Debtor were worthless on December 31, 1988 and December 31, 1989; (9) the Board has not introduced any evidence in this matter; (10) the deposition testimony of Leslie Szutenbach and John Haegen establish the existence and amounts of loans claimed by Debtor; (11) the testimony of Leslie Szutenbach and Karen Joyce and the documents offered by Debtor, including the admissions of Cheng, establish that Cheng was insolvent as of December 31, 1988 and December 31, 1989 and (12) the evidence offered by Debtor is not controverted by the Board.

DISCUSSION

A. Standard of Review

The district court acts as an appellate court when reviewing appeals from the bankruptcy court. 28 U.S.C. §158(a). The court must review the bankruptcy courts findings of fact under the clearly erroneous standard, and conclusions of law de novo. Fed. R. Bankr. P. 8013. Under the clearly erroneous standard, this court will not disturb the bankruptcy court's findings of fact if "the evidence is plausible in light of the record viewed in its entirety." *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985). This court must review a grant of summary judgment by the bankruptcy court de novo. *Crane v. The Arizona Republic*, 972 F.2d 1511, 1516 (9th Cir. 1992).

The procedural history in this case indicates that the bankruptcy court had both a motion for denial of claim and a motion for summary judgment on denial of the claim before it at the July 12, 1993, hearing. The docket of the bankruptcy court indicates that the Debtor had filed an Objection To The Board's Proof of Claim, on January 11, 1993 (#181) and a Motion For Summary Determination Denying The Board's Claim on June 11, 1993 (#236). Accordingly, this court must consider this matter as both an appeal from a summary judgment and an appeal from the bankruptcy court's decision on the merits of the Board's Proof of Claim.

B. Burden Of Persuasion.

There is a conflict between the circuits with respect to the ultimate burden of persuasion regarding tax claims in

contested matters in bankruptcy court; particularly those with respect to entitlement to bad debt deductions.

Under the tax code, the burden of persuasion is on the taxpayer to prove entitlement to a claimed deduction. Deductions are a matter of legislative grace, and the taxpayer must show that every condition imposed by Congress is satisfied. *Levy v. Conlon*, 973 F.2d 265, 269 (5th Cir. 1992); *Keogh v. C.I.R.*, 713 F.2d 496, 501 (9th Cir. 1983).

On the other hand, in bankruptcy court, a proof of claim establishes a prima facie case against the debtor's assets. The objecting party must then produce evidence rebutting the claimant, or the claimant will prevail. If, however, evidence rebutting the claim is brought forth, then the claimant must produce additional evidence to prove the validity of the claim by a preponderance of the evidence. The ultimate burden of persuasion rests upon the claimant. *California State Board Of Equalization v. Official Unsecured Creditors' Committee*, 837 F.2d 696, 698 (5th Cir. 1988).

The issue before the court is whether in the context of a bankruptcy proceeding, the burden of showing entitlement to a deduction for bad debts shifts from the taxpayer to the Board. The court in *Levy* discussed the conflict in the circuits on this issue. The *Levy* court found that the majority of circuits which have addressed the issue have decided that a dispute between a taxpayer and a taxing agency should not be decided in a bankruptcy context any different than it would be outside of a bankruptcy forum. Following this line of precedent, the Debtor would retain the burden of proving its bad debt deduction was proper. *See Resyn Corp. v. United States*, 851

F.2d 660, 662-63 (3rd Cir. 1988); *United States v. Uneco Inc.*, 532 F.2d 1204, 1207 (8th Cir. 1976). There is an alternative line of authority which holds that the Bankruptcy Code does not differentiate between government and private claimants when proofs of claim are filed. Under this authority, the Board would have the ultimate burden of persuasion concerning the validity of the bad deduction. *See California State Board Of Equalization*, 837 F.2d at 698; *Cebollio v. C.I.R.*, 967 F.2d 986, 989-990 (4th Cir. 1992) (taxpayer has burden to show the taxing agency's deficiency notice is in error, burden shifts to agency to determine correct amount of deficiency.).

This is an issue of first impression in the Ninth Circuit. However in *In re Imperial Corporation of America*, a bankruptcy court in the Southern District of California held that the party making a claim against the estate of the debtor has the burden of establishing all requisite elements of its claim, even if the claimant is the IRS. *In re Imperial Corporation of America*, 1991 WL 281712 (Bankr. S.D. Cal.).

This court is not bound to follow either line of authority. A review of the language of the Bankruptcy Code offers little guidance on this issue. Courts have interpreted this omission in different ways. For example, the court in *California State Board of Equalization v. The Official Unsecured Creditor's Committee*, the court held that burden of persuasion is on the taxing agency to prove the validity of their claim because Bankruptcy Rule 3001 does not differentiate between the government and private claimants when a proof of claim is filed. *California State Board of Equalization*, 837 F.2d at 698. On the other hand, the court in *Internal Revenue Service v. Levy*, held that

taxpayers have the burden of proving they are entitled to deductions even in a bankruptcy forum. The *Levy* court stated, "Thus upon review of the [Bankruptcy] code and its legislative history, we find nothing which suggests that this dispute between a taxpayer and the IRS should be decided in a manner any different from that in which the case would be determined outside the bankruptcy context." *Levy*, 973 F.2d at 271. Thus the court finds that the language of the statute does not provide a clear path to resolve this issue.

The court, after finding there is no binding statutory language or case authority which resolves this issue, finds there is an equitable argument which supports assigning the Board the burden of persuasion in this case. Bankruptcy courts sit as courts of equity. *In re Shoreline Concrete Co., Inc.*, 831 F.2d 903, 905 (9th Cir. 1987). (citations omitted). The Supreme Court has stated: the "touchstone of each decision on allowance of interest in bankruptcy . . . has been a balance of equities between creditor and creditor or between creditor and the debtor." *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 248 (1989). This language in *Ron Pair Enterprises, Inc.*, suggests that this court should take into account the balance of equities between the Board and the other creditors of Debtor's estate.

Under applicable statutory law, tax claims may be afforded priority over other creditors' claims under 11 U.S.C. §507(a)(7)(A)(i), (ii), (iii) if the tax was due prepetition, or if the tax could have been assessed prior to the debtor's petition. If this court relieves the Board of its burden of persuasion, it would be granting the Board a double benefit not authorized by statute or Ninth Circuit

authority. The Board's tax claim may be afforded priority over the claims of other creditors, without the Board having the same obligation of other creditors to prove by a preponderance of the evidence, the validity of their claim.

In their papers, the Board argues that this court should not apply the equitable objective of equality in distribution at the claims allowance stage of the process. Instead, the Board argues, the court should only consider equality of treatment for allowed claims and should apply the clear mandate of bankruptcy courts to apply non-bankruptcy law to the claims adjudication process.

The court rejects this argument because it is not well supported. The Board has provided an abundance of case law to show that bankruptcy courts have applied non-bankruptcy substantive law to other issues in the claims adjudication process. (Appellant's Opening Brief pp. 12-14). However, the Circuits are split with respect to whether federal tax law should be applied in this instance. This is a far cry from a clear mandate that this court must apply tax law to the burden of proof issue in this appeal.

Additionally, the Board has cited no authority suggesting that bankruptcy courts, which sit as courts of equity, should not apply equitable principles during the claims allowance phase of the bankruptcy proceeding. In the Ninth Circuit, bankruptcy courts must follow the law in the same manner as other courts of equity. *In re Shoreline Concrete Co., Inc.*, 831 F.2d at 905. However, the Board's argument that this court cannot apply equitable

principles at the claims allowance stage begs the question. The Board must first establish that there is statutory or case authority which dictates applying tax law to the burden of persuasion issue, before the court can find that the bankruptcy court did not follow the law. The Board failed to provide sufficient authority that this court must apply tax law to the burden of persuasion issue in this appeal, and therefore, the court rejects the Board's argument.

Based on the facts presented and the reasoning of the authorities cited above, the court holds that the Board has the ultimate burden of persuasion to prove the validity of its claim.

C. Standards For Bad Debt Deduction

This court must look at the financial condition of the debtor and the circumstances relating to the debt to determine if a bad debt deduction is appropriate. In order for a taxpayer to take a bad debt deduction, the applicable statute requires: (1) the existence of a debt; (2) the debt had value at some time during the taxable year; (3) the debt became worthless during the taxable year; (4) and there was a reasonable expectation of repayment. 26 U.S.C. §166.

A valid debt is an enforceable obligation to pay a fixed or determinable sum of money. *Piggy Bank Stations, Inc. v. C.I.R.*, 755 F.2d 450, 453 (5th Cir. 1985). The question of whether the payments or distributions of a taxpayer are debts for tax purposes is a question of fact. *Id.* at 454; *Los Angeles Shipbuilding & Drydock Corp. v. United States*, 289 F.2d 222 (9th Cir. 1961). In the *Piggy Bank*

Stations decision, the court considered the following factors to determine if a cash distribution was a valid debt: (1) the names given to the instruments evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and repayment schedule; (3) whether any security was given; (4) the intent of the parties; (5) the ability of the receiving party to obtain loans from third-party lenders; (6) the failure of the debtor to repay on the due date or seek a postponement. In *Stinnett's Pontiac Service Inc. v. C.I.R.*, 730 F.2d 634, 638 (11th Cir. 1984) the court indicated how the multi-factor test should be applied: "the approach of this court has been to consider all the factors and weigh the evidence favoring characterization of the advance as debt or equity, while realizing that the various factors are not of equal significance and that no one factor is controlling." *Id. quoting, Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972).

If the distribution of cash by the Debtor is considered a debt, than the court must determine if the loan had any potential or current intrinsic value in the beginning of the year in which it allegedly becomes worthless and that it actually becomes worthless during the year in question. *Estate of Mann*, 731 F.2d 267, 275 (5th Cir. 1984). Worthlessness in a particular year is a question of fact. *Id.* The *Estate of Mann* court held that:

> A taxpayer must prove that on January 1 of the taxable year the debts had some intrinsic or potential value, and that by December 31 the debts had lost all such value . . . Debts are wholly worthless when there are reasonable grounds for abandoning any hope of repayment in the future. . . . This will usually entail proof of

> the existence of identifiable events which demonstrate the valuelessness of the debts . . . If and when such debt becomes wholly worthless must be determined from the facts and circumstances known or which could have reasonably been known at the end of the year of asserted worthlessness.

Id. at 275-76.

D. Review of the Bankruptcy Court's Findings of Fact

The record before the court establishes that the bankruptcy court's holding that the Debtor established that his cash distributions to Cheng were loans and that the loans were worthless in 1988 and 1989 should be affirmed under the clearly erroneous standard for findings of fact. Whether distributions by a taxpayer are debts is a question of fact. *Piggy Bank Stations Inc.*, 755 F.2d at 454; *Los Angeles Shipbuilding & Drydock Corp.*, 289 F.2d at 222. Similarly, the question of when a debt becomes worthless is also a question of fact. *Estate of Mann*, 731 F.2d 267, 275 (5th Cir. 1984). Proof of the validity of a claim must be made by a preponderance of the evidence. *California State Bd. of Equalization v. Official Unsecured Creditor's Committee*, 837 F.2d 696, 698 (5th Cir. 1988).

At the July 12, 1993 hearing, the bankruptcy court stated that it relied on a January 1987 letter from the Debtor to Cheng when the court found that the funds Debtor advanced to Cheng were loans. R.A. 75. In that letter, Cheng expressly indicated that the parties were entering into a secured lender relationship and not an investment relationship. R.A. 547-48.

The court also indicated that it considered other evidence that the Debtor and Cheng established a lender relationship. R.A. 76. This evidence includes multiple copies of checks which indicate "loan" on the memo line, a February 26, 1987 note which indicates a $500,000 loan, a May 6, 1987 loan which increased the prior loan by $250,000, a May 25, 1987 unsecured promissory note for $250,000, a February 18, 1987 unsecured promissory note for $250,000, and an undated promissory note for $1,000,000. R.A. 547-559.

The bankruptcy court also considered the following evidence: a July 31, 1988 loan agreement between Debtor and Cheng which acknowledged a loan of $1,250,000 and a June 28, 1988 letter from Cheng's legal counsel which characterized the transactions between Cheng and Debtor as loans; R.A. 1004-10013, a July 19, 1988 promissory note for $600,000 R.A. 1001; and a promissory note dated September 25, 1987, which contains an interest rate and a repayment schedule. R.A. 1003.

In addition, the bankruptcy court rejected the Board's argument that the Debtor could not have had a reasonable expectation of repayment of funds advanced in 1989, after the Debtor signed his 1988 tax return which indicated a bad debt deduction for Cheng in 1988. The bankruptcy court found that the 1988 tax returns were not signed until October of 1989, and the fact that Cheng was unable to pay back his 1988 obligations does not establish that he was unable to pay obligations made on loans in 1989. R.A. 74.

The bankruptcy court also rejected the Board's contention that the all-inclusive power of attorney the Debtor

gave Cheng is inconsistent with an intent to make a loan to Cheng. The bankruptcy court held that the Debtor's evidence established that he intended to have a debtor/creditor relationship with Cheng and the Board had the burden to show a particular transaction during 1988 and 1989 was not a valid loan. R.A. 78, 81.

The bankruptcy court further found that the Board had the burden to prove that the Debtor advanced some of the funds to Cheng to generate a loss for a tax shelter. R.A. 77. The bankruptcy court rejected the Board's argument that the Debtor's deposition testimony indicating that he needed a tax shelter, establishes the Debtor did not advance funds to Cheng with a reasonable expectation of repayment. The bankruptcy court found that the Board failed to provide any evidence indicating that Cheng used the Debtor's funds in a manner which established it was not a loan.

The Board also argued that the cash advances from Debtor to Cheng evidenced by unsecured promissory notes should not be considered loans, because cash advances for large sums of money usually require security. The Board cites *Matter of Uneco, Inc.*, 532 F.2d 1204 (8th Cir. 1976) for the proposition that the absence of an assignment of security has been viewed by many courts as a key factor against finding bona fide indebtedness. However the Board failed to indicate that the *Uneco* court also held that when determining the validity of a bad debt deduction, there is no one controlling factor or broad rule that can be used in deciding these cases. *Id.* at 1208. The *Uneco* court held that each case turns upon its particular facts and the varying indicia applied in determining the issue may or may not have relevancy to a

particular case. *Id.* at 1207. Based on the reasoning of the *Uneco* case cited by the Board, the court rejects the Board's argument that the absence of security in certain promissory notes indicates that the transactions were not loans.

The record before the bankruptcy court also indicates that the Debtor provided evidence that the loans were worthless in 1988 and in 1989. The bankruptcy court considered the deposition testimony of Leslie Szutenbach, Cheng's former accountant. R.A. 72. Ms. Szutenbach testified that Cheng informed her he was unable to pay back the debtor and instructed her to write off the loans as bad debt the [sic] Debtor's tax return. R.A. 743, 744. The bankruptcy court also considered the declaration of Karen Joyce, Cheng's former bookkeeper. R.A. 73. Joyce's declaration indicated that Cheng did not have the ability to pay back the loans to the Debtor in 1988 and 1989. R.A. 560-564.

The Board argues that the Debtor's failure to indicate an identifying event showing that the debts to Cheng were worthless in 1988 and 1989 precludes the court form finding that the debt became worthless in the taxable year of the deduction. The case law indicates that proof of an identifiable event is generally required to show proof of worthlessness. *Estate of Mann*, 731 F.2d 267, 275 (5th Cir. 1984). However, the Board has provided no authority which indicates that an identifiable event is an essential element of proof of worthlessness, or that the bankruptcy court is required to find an identifiable event which signals that the loans are worthless. The bankruptcy court is not required to find an identifiable event which signals that the loans are worthless. The Supreme Court had held

that "if the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse even though convinced that had it been sitting as the trier of fact, it would have weighed the evidence differently. *Anderson v. City of Bessemer City*, 470 U.S. 564, 574 (1985). In this case, the bankruptcy court's factual finding is plausible. The bankruptcy court relied on the testimony of percipient witnesses who testified that Cheng did not have the ability to repay the Debtor. In *Cole v. C.I.R.*, the court held that facts which might support a claim of worthlessness include the lack of assets of the creditor. *Cole v. C.I.R.* 871 F.2d 64, 67 (7th Cir. 1989). It is not implausible for the bankruptcy court to consider the uncontested evidence of Cheng's accountant and bookkeeper as sufficient evidence that Cheng did not have the ability to repay the Debtor.

The court finds that there is sufficient evidence to support the bankruptcy court's finding that the transactions between the Debtor and Cheng were loans and that the loans were worthless in 1988 and 1989.

The bankruptcy court's finding that the transactions were loans and the debts were worthless in 1988 and 1989 was not clearly erroneous. The bankruptcy court took into account the following factors: the instruments evidencing the transaction indicated they were loans; some of the promissory notes indicated a repayment date and interest, the parties indicated in correspondence that the transactions were considered loans and not investments, in a letter to debtor Cheng pledged security for the loans, and the declaration and affidavit testimony of Cheng's

former accountant and bookkeeper that Cheng was unable to repay the Debtor in 1988 and 1989.

In their papers, the Board incorrectly assumed that this court would only be reviewing the case under the de novo standard. As a result, the Board did not address the bankruptcy court's ruling under the clearly erroneous standard.

Based on the facts presented and the reasoning of the authorities cited above, the court finds the bankruptcy court's ruling was not clearly erroneous and affirms the bankruptcy court's findings of fact.

E. Review of The Bankruptcy Court's Grant of Summary Judgment

The court must also determine under the de novo standard whether the bankruptcy court properly granted summary judgment on the issue of whether the Debtor loaned money to Cheng.

Fed. R. Civ. P. 56(c) provides that summary judgment is appropriate if the "pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." One of the principal purposes of the rule is to dispose of factually unsupported claims or defenses. *Celotex Corp. v. Catrett*, 477 U.S. 317, 325 (1986).

Once the moving party meets the requirement of Rule 56 by either showing that no genuine issue of material fact remains or that there is an absence of evidence to

support the non-moving party's case, the burden shifts to the party resisting the motion, who "must set forth specific facts showing that there is a genuine issue for trial." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 256 (1986). It is not enough for the party opposing a properly supported motion for summary judgment to "rest on mere allegations or denials of his pleadings." *Id.* Genuine factual issues must exist that "can be resolved only by a finder of fact because they may reasonably be resolved in favor of either party." *Id.* at 250.

To make such a showing, the non-moving party must go beyond the pleadings to designate specific facts showing that there is a genuine issue for trial. *Celotex*, 477 U.S. at 325. The court must draw all inferences in favor of the party opposing summary judgment. Summary judgment will only be granted if all reasonable inferences defeat the opposing party's claim. *Admiralty Funds v. Tabor*, 677 F.2d 1297, 1298, 1299 (9th Cir. 1982).

The record before the court indicates that in addition to the checks, promissory notes and loan agreements mentioned by the bankruptcy court during the July 12, 1993 hearing, there is also deposition testimony by the Debtor that he loaned money to Cheng. See R.A. 338,354,356,364.

In their papers, the Board argues that the evidence offered by the Debtor is controverted and creates a genuine issue of triable fact concerning whether the funds Debtor advanced Cheng were debts for tax purposes. The Board offered the following detrimental aspects of the Debtor's evidence to show that no valid debt existed between the Debtor and Cheng.

The Debtor testified in his deposition that Cheng did not have permission to use the Debtor's money for the purposes it was used. R.A. 338. The Board argues this creates an issue of whether the Debtor expected repayment of funds that he advanced without knowing how Cheng used the money.

The Debtor also testified in his deposition that he discussed with Cheng about investing in tax shelters to lessen his tax burden. R.A. 255. The Board argues that this statement creates an issue of whether the Debtor advanced funds to Cheng with an expectation of repayment or to generate a tax loss. The Board concedes that the extent to which these cash advances from the Debtor to Cheng represent tax shelter activity is unknown. Although the Board has the ultimate burden of proof to establish to what extent the funds advanced to Cheng were for the purpose of a tax shelter, the Board has pointed to sufficient evidence in the record to create a triable issue that some of the funds were not loans and were used to generate a tax loss.

The Debtor testified that he was unable to distinguish cash advances to Cheng as a loan, from cash advances given to Cheng for investing. R.A. 356-57. The Debtor also testified that at least $1,000,000 of the cash advance to Cheng was an investment in an entity called Cheng Information Systems. R.A. 359. The Board argues that this testimony creates an issue as to whether the funds advanced to Cheng were loans or investments.

The Board also points to documents in the record which raise inferences that the Debtor did not have a valid bad debt deduction in 1988 and 1989. The Board

pointed out two promissory notes dated February 26, 1987 and May 6, 1987, in which the Debtor is offering to lend Cheng $500,000 and $750,000 that do not contain a repayment date, do not bear an interest rate, and do not contain any security. R.A. 549-550. The Board argues that the court could infer that these documents do not evidence a valid debt. These unsecured promissory notes satisfy few of the factors courts analyze to determine whether a debt is valid for tax purposes.

Although the instruments are entitled promissory notes, they do not contain a fixed maturity date and repayment schedule, they do not contain any security, and would not be commercially acceptable to third-party lenders. The court finds that the Board has pointed to sufficient evidence in the record to defeat summary judgment on the issue of whether the promissory notes evidence valid debts.

As noted earlier, the court declines to disturb, under the clearly erroneous standard, the bankruptcy court's finding of fact on the merits. The bankruptcy court found that the debtor established a lender/creditor relationship with Cheng, and the Board failed to meet its burden of showing these particular transactions were not valid loans. The court's rulings are not inconsistent. The bankruptcy court's findings of facts on the merits are reviewed under the clearly erroneous standard, while the motion for summary judgment is reviewed de novo.

To survive summary judgment under *Celotex*, the Board must set forth specific facts showing there is a genuine issue for trial. The Board cited numerous excerpts from the record, which create a genuine issue of

triable fact whether the funds the Debtor advanced to Cheng were loans. In summary, The Board cited the following evidence: Debtor testified that Cheng did not have permission to use his money for the purposes in which it was used (R.A. 338); Debtor testified that he needed a taxable loss to lessen his tax bill (R.A. 255); the alleged loans are totally unsecured, despite the language of a January 12, 1987 letter that the loans would be secured by pledges of stock (R.A. 549-50); and promissory notes dated February 26, 1987 and May 6, 1987, that do not contain a date the alleged loan is due, an interest rate, or security (R.A. 549-50). Viewing all inferences that can be drawn from the excerpts of the record cited by the Board in a light most favorable to the Board, the court finds that all reasonable inferences do not defeat the Board's claims.

Accordingly, based on the reasoning of the *Celotex* and the *Admiralty Funds* decisions and the facts presented, the court reverses the bankruptcy court's grant of summary judgment.

CONCLUSION

The bankruptcy court's findings of fact and conclusions of law on the motion for denial of claim, bankruptcy docket #181, are affirmed and the bankruptcy court's grant of summary judgment denying the Board's claim, bankruptcy docket #236 is reversed.

IT IS SO ORDERED.

Date: 6/10/95

/s/ John S. Rhoades
JOHN S. RHOADES
UNITED STATES
DISTRICT JUDGE

APPENDIX "C"



ELMER DEAN MARTIN III #75517
A Professional Corporation
1081 Grand Avenue, Suite G
P. O. Box 4670
Diamond Bar, California 91765
(909) 861-6700

Special Counsel for Debtor Stephen B. Macfarlane

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

In re	)	Case No. SD 90-11375 B11
STEPHEN B. MACFARLANE,	)	Chapter 11
Debtor.	)	JUDGMENT DENYING FRANCHISE TAX BOARD CLAIM
	)	DATE: July 12, 1993
	)	TIME: 2:00 o'clock p.m.
	)	PLACE: 940 Front Street Department 4 San Diego, Cal.

(Filed Aug. 10, 1993)

The motion of the Debtor for a denial of the claims of the California Franchise Tax Board on file in this case and for determination of Debtor's personal liability for the taxes represented by such claims in the contested matter commenced by Debtor's objection to such claims came on for hearing on July 12, 1993 before the Honorable Peter W. Bowie, United States Bankruptcy Judge in Department

4 of the United States Bankruptcy Court for the Southern District of California.

The Court having considered the evidence offered by the Debtor and the arguments of the parties and having made its Findings of Facts and Conclusions of Law on file herein,

IT IS HEREBY ADJUDGED, ORDERED AND DECREED:

1) The claims of the California Franchise Tax Board in this case for income taxes measured by Debtor's taxable income for 1988 and 1989 are denied and the California Franchise Tax Board shall receive no payment from Debtor's estate in this case;

2) The personal liability of the Debtor to the California Franchise Tax Board for interest, additions or penalties measured by Debtor's taxable income for 1988 and 1989 is determined to be zero and the California Franchise Tax Board shall receive no payment from Debtor for the taxes, interest, additions or penalties claimed by the California Franchise Tax Board in its claims in this case.

Dated: AUG 10 1993, 1993.

/s/ Peter W. Bowie
United States Bankruptcy Judge

ELMER DEAN MARTIN III #75517
A Professional Corporation
1081 Grand Avenue, Suite G
P. O. Box 4670
Diamond Bar, California 91765
(909) 861-6700

Special Counsel for Debtor Stephen B. Macfarlane

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

In re	Case No. SD 90-11375 B11
STEPHEN B. MACFARLANE,	Chapter 11
Debtor.	FINDINGS OF FACT AND CONCLUSIONS OF LAW REGARDING FRANCHISE TAX BOARD CLAIMS
	DATE: July 12, 1993
	TIME: 2:00 o'clock p.m.
	PLACE: 940 Front Street, Department 4, San Diego, Cal.

(Filed Aug. 10, 1993)

The Motion of the Debtor for a denial of the claims of the California Franchise Tax Board on file in this case and for determination of Debtor's personal liability for the taxes represented by such claims in the contested matter commenced by Debtor's objection to such claims came on for hearing on July 12, 1993 before the Honorable Peter

W. Bowie, United States Bankruptcy Judge in Department 4 of the United States Bankruptcy Court for the Southern District of California. Debtor appeared by Elmer Dean Martin III and the California Franchise Tax Board appeared by Anthony Sgherzi, Deputy Attorney General of the State of California.

The Court having considered the record and pleadings in this contested matter and the oral arguments, the Court hereby finds:

1. The California Franchise Tax Board filed its claims in the above captioned case for income taxes, interest, additions and penalties claimed to be due from Debtor measured by his taxable income for 1988 and 1989.

2. The Debtor filed an objection to such claims, offered admissible evidence in opposition to such claims, and requested a determination of his personal liability and the liability of his estate in the above captioned case.

3. Debtor timely filed income tax returns for 1988 and 1989 with the California Franchise Tax Board claiming as deductions from income nonbusiness bad debt amounts claimed to be due to Debtor from William Cheng.

4. The deductions claimed by Debtor on these returns were $1,400,000 for 1988 and $1,378,141 for 1989.

5. Prior to December 31, 1988, Cheng had obtained at least $1,632,500 from Debtor and promised to repay this amount.

6. In 1989 Cheng obtained an additional $2,047,232, to $2,224,077 from Debtor and promised to repay this amount.

7. Cheng prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns which claimed the deductions described in statement number 4 above for amounts due from Cheng.

8. Cheng knew when he prepared Debtor's 1988 and 1989 California Franchise Tax Board income tax returns that he could not repay the amounts he had borrowed from Debtor and accordingly prepared the returns to claim a loss for amounts due from him.

9. In April 1991 Cheng commenced a bankruptcy case under Chapter 15 of Title 11 U.S.C., and his case was converted to Chapter 7 in May 1991. Cheng admitted in his bankruptcy schedules of liabilities that he was indebted to Debtor in the amount of $2,939,722.00

10. Cheng's bankruptcy estate has little or no value.

11. The primary asset of Cheng's estate was stock in Cheng Information Systems, Inc.

12. All of the property of Cheng Information Systems, Inc. was sold by its trustee for $2,500.

13. On December 31, 1988 and December 31, 1989, Cheng's promises to pay to Debtor amounts owed to him as of such dates were worthless.

14. As of December 31, 1988 and December 31, 1989, Debtor had no realistic prospect of recovery from Cheng of any of the amounts then due to Debtor.

15. Cheng was unable to obtain a loan in 1988 or 1989 without Debtor's accommodation as a co-maker.

16. Debtor and Cheng signed documents evidencing an intent to enter into a debtor and creditor relationship and each stated orally to witnesses from time to time that a debtor-creditor relationship between them existed.

17. Cheng was in dire financial straits in 1988 and by the end of 1989 was living off loans.

18. Debtor loaned a total of $4,529,349 to Cheng.

Upon consideration of the foregoing facts the Court makes the following Conclusions of Law:

1. This Court has jurisdiction over this matter under 11 U.S.C. Sections 502 and 505, 28 U.S.C. Sections 157 and 1334, the consent of the parties, and the confirmed plan of reorganization of the Debtor.

2. The claim of the California Franchise Tax Board in issue here is presumptively entitled to prima facie validity until Debtor presents admissible evidence which tends to rebut the presumption of validity.

3. The Debtor in this contested matter has presented admissible evidence which tends to rebut the presumption of validity of the claim in issue.

4. The California Franchise Tax Board has the ultimate burden of persuading the court that the facts indicate more probably than not the validity and priority of its claim in issue.

5. A debt for purposes of this contested matter is an obligation to pay money.

6. Cheng agreed to repay to Debtor at least the amounts claimed by Debtor on his 1988 and 1989 returns.

7. A debt becomes deductible for the purposes of this contested matter when it becomes worthless.

8. A debt becomes worthless when there is no reasonable possibility of repayment and there are reasonable grounds for abandoning any hope of repayment in the future.

9. Cheng was indebted to Debtor in the amounts and at the times claimed by Debtor, and such debts were worthless on December 31, 1988 and December 31, 1989 as claimed by Debtor.

10. The California Franchise Tax Board has had an adequate opportunity for discovery. The only evidence offered has been offered by the Debtor. The testimony of Leslie Szutenbach and John Haegen in their depositions establish the existence and amount of loans claimed by the Debtor. The testimony of Leslie Szutenbach, the declaration of Karen Joyce and the documents offered by the Debtor, including the admissions of Cheng, establish that Cheng was insolvent on December 31, 1988 and December 31, 1989 and that there was no reasonable prospect of recovery of the loans in issue on those dates. The evidence offered by the Debtor is not controverted by the California Franchise Tax Board. Accordingly the Court concludes that there is no issue of material fact raised by the evidence before the Court which is in reasonable dispute.

11. No material conclusion of law is in reasonable dispute.

12. A judgment should be entered denying the claims of the California Franchise Tax Board in issue and determining that Debtor has no liability for the amounts claimed.

Dated this 10th day of August 1993.

/s/ Peter W. Bowie
United States Bankruptcy Judge

APPENDIX "D"

Section 8, Clause 4. Naturalization and Bankruptcy

To establish an uniform Rule of Naturalization, and uniform Laws on the subject of Bankruptcies throughout the United States;

* * *

---

§ 1254. Courts of appeals; certiorari; certified questions

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

(2) By certification at any time by a court of appeals of any question of law in any civil or criminal case as to which instructions are desired, and upon such certification the Supreme Court may give binding instructions or require the entire record to be sent up for decision of the entire matter in controversy.

(June 25, 1948, ch 646, § 1, 62 Stat. 928; June 27, 1988, P. L. 100-352, § 2(a), (b), 102 Stat. 662.)

---

§ 505. Determination of tax liability

(a)(1) Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

(2) The court may not so determine –

(A) the amount or legality of a tax, fine, penalty, or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under this title; or

(B) any right of the estate to a tax refund, before the earlier of –

(i) 120 days after the trustee properly requests such refund from the governmental unit from which such refund is claimed; or

(ii) a determination by such governmental unit of such request.

(b) A trustee may request a determination of any unpaid liability of the estate for any tax incurred during the administration of the case by submitting a tax return for such tax and a request for such a determination to the governmental unit charged with responsibility for collection or determination of such tax. Unless such return is fraudulent, or contains a material misrepresentation, the trustee, the debtor, and any successor to the debtor are discharged from any liability for such tax –

(1) upon payment of the tax shown on such return, if –

(A) such governmental unit does not notify the trustee, within 60 days after such request, that such return has been selected for examination; or

(B) such governmental unit does not complete such an examination and notify the trustee of any tax due, within 180 days after such request or within such additional time as the court, for cause, permits;

(2) upon payment of the tax determined by the court, after notice and a hearing, after completion by such governmental unit of such examination; or

(3) upon payment of the tax determined by such governmental unit to be due.

(c) Notwithstanding section 362 of this title, after determination by the court of a tax under this section, the governmental unit charged with responsibility for collection of such tax may assess such tax against the estate, the debtor, or a successor to the debtor, as the case may be, subject to any otherwise applicable law.

(Nov. 6, 1978, P. L. 95-598, Title I, § 101, 92 Stat. 2582; July 10, 1984, P. L. 98-353, Title III, Subtitle H, § 447, 98 Stat. 374.)

Rule 3001
PROOF OF CLAIM

(a) Form and Content. A proof of claim is a written statement setting forth a creditor's claim. A proof of claim shall conform substantially to the appropriate Official Form.

(b) Who May Execute. A proof of claim shall be executed by the creditor or the creditor's authorized agent except as provided in Rules 3004 and 3005.

(c) Claim Based on a Writing. When a claim, or an interest in property of the debtor securing the claim, is based on a writing, the original or a duplicate shall be filed with the proof of claim. If the writing has been lost or destroyed, a statement of the circumstances of the loss or destruction shall be filed with the claim.

(d) Evidence of Perfection of Security Interest. If a security interest in property of the debtor is claimed, the proof of claim shall be accompanied by evidence that the security interest has been perfected.

(e) Transferred Claim.

(1) *Transfer of Claim Other Than for Security Before Proof Filed.* If a claim has been transferred other than for security before proof of the claim has been filed, the proof of claim may be filed only by the transferee or an indenture trustee.

(2) *Transfer of Claim Other Than for Security After Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred other than for security after the proof of claim has been

filed, evidence of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If the alleged transferor files a timely objection and the court finds, after notice and a hearing, that the claim has been transferred other than for security, it shall enter an order substituting the transferee for the transferor. If a timely objection is not filed by the alleged transferor, the transferee shall be substituted for the transferor.

(3) *Transfer of Claim for Security Before Proof Filed.* If a claim other than one based on a publicly traded note, bond, or debenture has been transferred for security before proof of the claim has been filed, the transferor or transferee or both may file a proof of claim for the full amount. The proof shall be supported by a statement setting forth the terms of the transfer. If either the transferor or the transferee files a proof of claim, the clerk shall immediately notify the other by mail of the right to join in the filed claim. If both transferor and transferee file proofs of the same claim, the proofs shall be consolidated. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the estate, on motion by a party in interest and after notice and a hearing, the court shall enter such orders respecting these matters as may be appropriate.

(4) *Transfer of Claim for Security After Proof Filed.* If a claim other than one based on a publicly traded note,

bond, or debenture has been transferred for security after the proof of claim has been filed, evidence of the terms of the transfer shall be filed by the transferee. The clerk shall immediately notify the alleged transferor by mail of the filing of the evidence of transfer and that objection thereto, if any, must be filed within 20 days of the mailing of the notice or within any additional time allowed by the court. If a timely objection is filed by the alleged transferor, the court, after notice and a hearing, shall determine whether the claim has been transferred for security. If the transferor or transferee does not file an agreement regarding its relative rights respecting voting of the claim, payment of dividends thereon, or participation in the administration of the

* * *

---

§ 166. Bad debts.

(a) General rule. (1) Wholly worthless debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts. When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in

section 1011 for determining the loss from the sale or other disposition of property.

(c) Repealed.

(d) Nonbusiness debts. (1) General rule. In the case of a taxpayer other than a corporation –

(A) subsection (a) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

(2) Nonbusiness debt defined. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than –

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) Worthless securities. This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

(f) Cross references. (1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

* * *

ARTICLE 6

Deductions

§ 17201. Determination in accordance with Internal Revenue Code provisions

(a) Part VI of Subchapter B of Chapter I of Subtitle A of the Internal Revenue Code, relating to itemized deductions for individuals and corporations, shall apply, except as otherwise provided.

(b) Part VII of Subchapter B of Chapter I of Subtitle A of the Internal Revenue Code, relating to additional itemized deductions for individuals, shall apply, except as otherwise provided.

(c) Part IX of Subchapter B of Chapter I of Subtitle A of the Internal Revenue Code, relating to items not deductible, shall apply, except as otherwise provided.

Added Stats 1993 ch. 873 § 12 (AB 35), effective October 6, 1993.

Former Sections:

Former § 17201, similar to the present section, was added Stats 1983 ch. 488 § 29, effective July 28, 1983, and repealed Stats 1993 ch. 873 § 11 (AB 35), effective October 6, 1993.

Note – Stats 1993 ch. 878 provides:

SEC. 24. California law with respect to the health insurance deduction for self-employed individuals conforms to Section 162(*l*) of the Internal Revenue Code in Section 17201 of the Revenue and Taxation Code, as modified by Section 1727 [sic] of the Revenue and Taxation Code. The Legislature finds and declares that in order to ease compliance burdens on taxpayers and to avoid unnecessary administrative costs, the Franchise Tax Board shall administer the California provisions in substantially the same manner as the Secretary of the Treasury and the Internal Revenue Service administer Section 162(*l*) of the Internal Revenue Code to reflect the amendments made by Section 13174 of the federal Revenue Reconciliation Act of 1993. Consistent with this purpose and policy, the Legislature further declares its intent that affected taxpayers shall make an adustment for the health insurance deduction for self-employed individuals for California purposes in the same taxable year as the adjustment is made for federal purposes.

* * *

Bankruptcy Rule 9014

CONTESTED MATTERS

In a contested matter in a case under the Code not otherwise governed by these rules, relief shall be requested by motion, and reasonable notice and opportunity for hearing shall be afforded the party against whom relief is sought. No response is required under this

rule unless the court orders an answer to a motion. The motion shall be served in the manner provided for service of a summons and complaint by Rule 7004, and, unless the court otherwise directs, the following rules shall apply: 7021, 7025, 7026, 7028-7037, 7041, 7042, 7052, 7054-7056, 7062, 7064, 7069, and 7071. The court may at any stage in a particular matter direct that one or more of the other rules in Part VII shall apply. An entity that desires to perpetuate testimony may proceed in the same manner as provided in Rule 7027 for the taking of a deposition before an adversary proceeding. The clerk shall give notice to the parties of the entry of any order directing that additional rules of Part VII are applicable or that certain of the rules of Part VII are not applicable. The notice shall be given within such time as is necessary to afford the parties a reasonable opportunity to comply with the procedures made applicable by the order.